Rights of appeal

7.63 The Discussion Paper[47] states that reviews and appeals from decisions of the arbitrators should be limited. Further, awards will be given effect to notwithstanding the appeal/review unless the court orders otherwise on compelling grounds.

7.64 Appeals from decisions of the arbitrators should be strictly limited. It is entirely consistent with principles of commercial arbitration for rights of appeal to be limited. Indeed, in some circumstances, rights of appeal from decisions of commercial arbitration are removed altogether. Thus for example the Commercial Arbitration Acts in Australia permit the parties to exclude appeals by entering into an exclusion agreement. The Model Law on International Arbitration does not permit any appeals on questions of law or fact and only allows an award to be set aside on certain limited grounds unrelated to the merits of the award. This law was drafted by the United Nations Commission on International Trade Law and has been enacted in many countries.

7.65 In the context of the proposed access regime, appeals should be limited to the following matters:

- manifest excess of jurisdiction
- fraud or manifest procedural unfairness and
- manifest error of law

Furthermore, there should be no appeal as of right, but only by leave of the Court.

7.66 A costs disincentive should be imposed against appeals. If a party appeals and loses the appeal, that party should be required to pay the full costs of the appeal. As an additional disincentive, that party should pay the costs of arbitration (both parties' and arbitrators' costs). Further, the Court should have discretion to require payment of a monetary penalty if it finds the appeal was frivolous, vexatious or weak. Of course, if the party appealing wins the appeal, no costs penalty should be imposed against the other party.

7.67 Arbitral awards should be given effect to notwithstanding the appeal. The Court should have no power to order otherwise. There is little harm which can be caused by immediately acting on an arbitral award. In the case of the new entrant, it will not commence business unless it is satisfied with the arbitral award. In the case of the supplier of the service, the arbitral award will have been made following a thorough period of negotiation and arbitration proceedings. In these circumstances, it is highly unlikely that significant harm could accrue to the supplier of the service pending an appeal.

7.68 On the other hand, there is a considerable risk that appeal rights could be used to delay access. It is accepted that in many situations there will be significant

47 See paragraph 13(g) of Appendix A to the Discussion Paper.

commercial incentives for a dominant incumbent who is the supplier of a complementary network service to delay the implementation of access. All avenues for delay would, rationally, be pursued. This may include seeking interlocutory orders from a court to injunct an arbitral award pending appeal.

7.69 Such proceedings should not be entertained. Emphasis should be given to allowing access at the earliest possible time, in view of the Government's overriding objectives of enhancing competition and innovation.

7.70 Furthermore, if on appeal the arbitral award is altered, retrospective orders may be made. Even in this case, it is not entirely necessary for orders to be retrospective. In other words, it would be reasonable to require the parties to be bound by the terms of the arbitral award until an appeal court decides otherwise. Any order made by an appeal court would then be prospective. In general, Courts should have the ability to implement retrospective orders.

Joinder of parties and consolidation of proceedings

7.71 One issue which is not addressed by Appendix A to the Discussion Paper is joinder of parties and consolidation of proceedings. Joinder of parties in this context means the ability of a second entrant seeking access to the same monopoly facility to join the arbitration proceedings commenced between the first entrant and the owner of the monopoly facility. Consolidation of proceedings in this context means the bringing together of two separate sets of proceedings between two different entrants and the owner of the monopoly facility.

7.72 There is considerable inefficiency in conducting an arbitration proceeding between one entrant and the owner of the monopoly, while ignoring the position of a second entrant who is also seeking access to the same facility.

7.73 It must be recognised, though, that the basis on which a second entrant seeks access may be entirely different to the first entrant. Accordingly, the terms of access sought, and any resulting dispute, may have little resemblance between the first and second entrants.

7.74 On the other hand, there may be circumstances in which the second entrant is seeking access on identical terms to the first entrant. The question should be addressed whether the second entrant should be entitled to join any arbitration proceedings commenced by the first entrant, or consolidate two sets of arbitration proceedings which have already commenced.

7.75 Because of the different circumstances which may arise, decisions on joinder of parties and consolidation of proceedings should generally rest with the entrants. In other words, if both entrants agree to a joinder or consolidation, that should take place, and the dominant incumbent supplier of the service should not be entitled to object. The benefit of joinder and consolidation is, of course, efficiency in the dispute resolution process. In particular, the entrants will be able to share costs and expertise concerning the issues involved. The arbitrators will also benefit from having all relevant issues raised in the one proceeding for decision.

7.76 It is important, though, for either entrant to be free to object to joinder or consolidation. The objection may be made on the basis of confidentiality and competition. Through the arbitration process, the entrant is likely to reveal certain aspects of its commercial intentions and objectives in the related market. It may not wish to share that information with a second entrant.

7.77 This decision is best left to the entrants themselves. In other words, they will be in the best position to assess the similarity or otherwise of their individual circumstances, and the benefits which will flow from joinder or consolidation.

7.78 The right of joinder and consolidation should be given to the party seeking access, but the party should not be required to accept joinder and consolidation against its will except in the circumstances set out in the following paragraph.

7.79 Where the first party seeking access does not agree to joinder of another entrant, a dominant incumbent who is the supplier of a complementary network service may be faced with a multiplicity of arbitration proceedings. In some cases it may be appropriate to order consolidation even against the wishes of the first entrant. This would be the case where the first entrant's reasons for rejecting consolidation are clearly outweighed by the desirability of avoiding two or more proceedings. This judgment should be made by the arbitral tribunal.

7.80 The arbitral tribunal should be empowered but not required to order joinder and consolidation in these circumstances when requested by a second (or subsequent) entrant with the consent of the supplier of the service.

7.81 When joinder and consolidation occur the arbitral tribunal should have the power to make consequential orders for the conduct of the arbitration.

Type of award and final offer arbitration

7.82 The basic purpose of Final Offer Arbitration[48] is:

- to provide an incentive to the parties to make offers closest to some "ideal" outcome, in that way bringing the parties closer to agreement

- to narrow the scope of the arbitrator's final decision, as the arbitrator chooses between two offers which should have been brought closer together

7.83 The usual form of *one-part* Final Offer Arbitration is difficult to implement in the context of access disputes for the following reasons.

7.84 First, an access agreement involves a complex set of terms and conditions relating to the particular service in question. It involves determining and defining the type of services provided, which may include a range of factors such as the provision of information and the requisite compatibility standards. Price is determined on the basis of the range of services provided. Consequently, it would be difficult for the two parties to produce two final offers which are entirely compatible and which will allow

48 See paragraphs 4-7 of Appendix E to the Discussion Paper.

the arbitrator to merely choose between them. The arbitrator will be forced to make a range of decisions concerning the nature and scope of the services provided, and the prices to apply in those circumstances.

7.85 Secondly, Final Offer Arbitration is unlikely to assist in the clarification of economic issues concerning access. While the views of the parties may be polarised, that polarisation may be necessary at the outset to clearly illuminate the various economic issues at stake. In the *Clear v Telecom* litigation, Telecom should not be criticised for holding certain views about economic pricing for access. The major criticism of the litigation is the delay involved in obtaining a resolution of the different view points, and indeed the inability of the court system to deliver a resolution.

7.86 Thirdly, as outlined in the point above, the real problem with access determinations to date has not been the problem of "splitting the difference", but the problem of not achieving a resolution. The access regime with compulsory arbitration overcomes the difficulties previously experienced with timeliness and cost. In those circumstances, the detriment suffered by the parties remaining polarised is not insurmountable. A party will be disadvantaged if it maintains a polarised view which is unsustainable. There is an incentive inherent in any compulsory dispute resolution mechanism for parties to promote legally or economically justifiable positions. In these circumstances, Final Offer Arbitration is unnecessary.

7.87 Therefore, a *two-part* approach to the arbitral award is more appropriate for access disputes.

7.88 The first part of the arbitration seeks to define the service to be provided under the access agreement. The characteristics of the service would include:

- the definition of the service being provided
- other services, such as information services, which must be provided to support access
- methods of measuring and billing the service to be provided
- technical issues to be agreed, including issues which relate to safety
- other commercial terms which would normally be included in an access agreement, such as methods to resolve disputes

7.89 It is only once the scope of the access agreement has been properly defined that pricing for access can be agreed. *Consequently, the two-part process of arbitration contemplates an initial decision on the terms of the access arrangement, followed by a second decision on the pricing for access.*

7.90 The second part (the decision on pricing) should be made subject to sealed bid Final Offer Arbitration. At this stage, the impediments to Final Offer Arbitration noted above would be overcome. However, Final Offer Arbitration should not be undertaken if all the parties to the arbitration agree that the price should be determined by the arbitral tribunal in its award on terms and conditions of access.

7.91 The arbitral award should prescribe the terms and conditions for access. This will mean that there is no need for the parties to execute an access agreement following the arbitration. The arbitral award itself will constitute the access terms and conditions. This avoids any need for either party to take action to force the other party to enter into the access agreement. It also ensures that the arbitral award is final and binding, and neither party may argue for further terms and conditions to be included in the access agreement.

7.92 The arbitral award should be enforceable in the High Court[49].

Costs

7.93 A distinction can be drawn between the costs of the arbitration (including both the arbitrators' fees and all other expenses relating to the arbitration such as venue hire, secretarial costs and hotel and travel expenses) and the costs of the parties (being essentially legal costs)[50].

7.94 In particular, an award of costs as contemplated in the Discussion Paper should include all costs, both costs of the arbitration and the other parties' costs.

7.95 An arbitration procedure should also facilitate a process for ensuring financial security of the arbitration. Consequently, the arbitrators should be empowered to order the parties to deposit moneys on account of fees and expenses. Those advances should be provided equally by each party unless the arbitrators, in their discretion, determine otherwise. If one party refuses to pay, the other party should be invited to pay the first party's share. The award should deal with final liability for costs and may award the payment of interest to compensate for non-payment of an advance, and its funding by the other party, in the course of the arbitration.

7.96 If, as recommended, arbitrators are appointed by the parties, each party should settle the appropriate fees with its arbitrator. The presiding arbitrator's fees should be agreed by the parties and the arbitrator. Failing agreement between the parties, it should be settled by the President of the Arbitrators' Institute of New Zealand and the arbitrator.

7.97 In awarding costs, the arbitral tribunal should have a discretion to award an amount less than an arbitrator's fees if it determines that the fees are, in the circumstances, manifestly excessive.

Mandatory disclosure regime

7.98 The final enhancement to the light-handed regime which Bell South proposes is a mandatory disclosure regime applicable to Telecom for so long as it is the dominant incumbent.

7.99 Access networks in the telecommunications industry have certain similarities with line businesses in the electricity industry, both being characterised by high fixed costs and

49 As contemplated in paragraph 16 of Appendix A to the Discussion Paper.
50 The reference to costs in paragraph 15 of Appendix A to the Discussion Paper should be clarified.

large volumes of low value units passing over the network. Therefore, the disclosure regime for line businesses in electricity may be a good model for the implementation of a more appropriate telecommunications disclosure regime.

7.100 There are, however, significant differences between the two industries, some of which have been discussed earlier in these Submissions, in particular, in relation to dynamic efficiency and the greater pace of technological change within telecommunications. Other differences are:

- the number of companies in New Zealand operating as line businesses is much larger than the number of telecommunication companies offering network services (essentially, just Telecom)
- the number of services that are offered to customers is much greater in telecommunications leading to a higher proportion of shared costs. Thus, the cost allocation mechanism is of more importance
- there is no need to interconnect between differing distribution network operations, contrasting with telecommunications where there are two-way networks

7.101 The key differences must be reflected in a revised telecommunications disclosure regime.

7.102 In order to enhance market processes to achieve Government policy objectives of maximising the telecommunications sector's contribution to overall economic growth, and for the correct assessment of the impact of Telecom's agreement with its shareholder to restrict residential tariffs, the "access networks" should be segmented into, at a minimum, CBD, urban, suburban and rural, and possibly by typography. The variable nature of New Zealand's topography means that there are large differences in cost structure (hills, for example, have a considerable impact on cost and the introduction of competition)[51].

7.103 For competition and innovation to flourish in what has historically been monopoly areas, much faster provision of information by Telecom is needed. Financial and performance measures should be required to be disclosed every quarter, with auditing carried out once a year, or at greater frequency if requested by a party. The obligation to report on a quarterly basis should not be onerous since Telecom

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51 The key requirements of the Electricity (Information Disclosure) Regulations are:

- disclosure of separate audited financial statements between differing business units (line, energy trading and generation)
- disclosure of methodologies for allocations of costs, revenues, assets and liabilities between business units
- disclosure of transfer pricing between related parties
- disclosure of line pricing policies and methodologies
- disclosure of costs and revenues by load groups and the methodologies used for their allocation

Initial disclosure has only just been made by many of the electricity distribution companies. Thus, it is not possible to judge the success or otherwise of the electricity information disclosure regime. However, the large number of mergers and takeovers by industry participants that are occurring indicate the companies themselves see the need to enlarge to obtain benefits of scale and hence to increase both absolute and relative efficiency.

prepares and publicly discloses financial position statements every quarter. Given that technological change is affecting the telecommunications industry at a rapid rate and hence the risk of technical obsolescence is great the revaluation procedure should occur at least annually.

7.104 Given the large differences in costs of service and the restriction on revenues from residential customers, both costs and revenues within an area network should be apportioned to residential and business, with the allocation mechanism disclosed.

7.105 For telecommunications, there should be five elements of costs:

- traffic sensitive network costs
- non-traffic sensitive network costs
- fixed and common overhead costs
- non-network operating costs
- interconnection costs

7.106 For revenues, there should be four elements:

- usage related retail revenues
- access related retail revenues
- interconnect related revenues
- revenues for other services (e.g., call waiting, call forwarding)

7.107 The appropriate performance measures for the telecommunications industry should be:

- number of calls
- number of call minutes
- number of interconnect calls
- number of interconnect minutes
- number of customers

7.108 Such data for revenue, costs, and performance should have the following components:

- residential and business

- peak and off-peak
- local and long distance
- other services

7.109 Of key importance is the allocative mechanism adopted for cost allocation where costs are shared or common between differing services. The majority of costs in telecommunications are either shared or common and thus knowledge of the basis adopted for allocation is essential. It is recognised, for example, that there is significant ability to load costs onto less competitive areas.

7.110 It is likely that even rural areas will become subject to competition in the not too distant future, and therefore there will be less need for extensive disclosure. Telecom should therefore be subject to this strengthened disclosure regime for so long as it is dominant and it is bound by its agreement with its shareholder to restrict residential tariffs.

7.111 This disclosure will ensure that all network operators will have sufficient information to:

- become active competitors in the local loop at the appropriate time
- be able to negotiate with Telecom on interconnection on a fairly informed basis, and in particular on the extent of the impact that Telecom's agreement with its shareholder to restrict residential tariffs has on Telecom's profitability

APPENDIX A

Answers to Questions (1)-(16)

A.1 This Appendix answers the specific Questions (1)-(16) asked on pages 14-16 of the Discussion Paper. These answers are mostly summaries of relevant parts of the particular discussion in these Submissions of the broader issues raised by those specific questions.

The regulatory framework for determining access terms and conditions

Summary answer to Question (1)

QUESTION (1): Which of the following options for defining and enforcing the regulatory environment for vertically-integrated natural monopolies would best promote economic efficiency in a manner that is timely, certain and predictable?

(a) No principles (apart from the Commerce Act) with solution and enforcement by the courts (i.e., the status quo);

(b) No principles (apart from the Commerce Act) with resolution and enforcement by a new compulsory arbitration mechanism;

(c) Broad legislative principles with the courts;

(d) Broad legislative principles with compulsory arbitration;

(e) Broad legislative principles with a statutory regulatory agency (such as the Commerce Commission);

(f) Detailed industry-specific principles with the courts; and

(g) Detailed industry-specific principles with compulsory arbitration.

A.2 An approach which specifies no principles, apart from section 36 of the Commerce Act, is fundamentally flawed. Detailed industry-specific principles are not consistent with New Zealand's light-handed regulatory approach. Accordingly, broad and non-prescriptive legislative principles must be introduced to govern the determination of access terms.

A.3 The factors of precedent value and the rules for determining standing and admissibility of evidence have limited significance in the selection of the most appropriate regulatory institution for an access regime. Accordingly, the Courts are inappropriate to act as the regulatory institution for an access regime.

A.4 Both arbitrators and a statutory regulatory agency are able to impose the more flexible range of solutions required for access disputes. The factors of cost and delay of making decisions and taking action, and of access to technical and economic expertise, can be made relatively neutral between arbitrators and a statutory regulatory agency (such as the Commerce Commission). The determinative issue on the selection of arbitrators or a regulatory agency is vulnerability to outside influence. Accordingly, because regulators are vulnerable to outside influence, compulsory arbitration is the most appropriate regulatory institution to achieve economic efficiency, as it encourages the continued use of market processes to resolve access issues.

A.5 *Broad legislative principles with compulsory arbitration as in (d) will therefore best promote economic efficiency in a manner that is timely, certain and predictable.*

Summary answer to Question (2)

QUESTION (2): If broad legislative principles were adopted, would the following principles promote the objectives set out in the question above?

(a) The extent to which competition is lessened or likely to be limited in the relevant market;

(b) The necessity or desirability of safeguarding the interests of consumers; and

(c) The promotion of efficiency in the production and supply or acquisition of the controlled service.

A.6 There is little doubt that the principles set out in paragraph 195 of the Discussion Paper, other than the safeguarding of the interests of consumers, will promote economic efficiency in a manner that is timely, certain and predictable.

A.7 The objectives of Government policy which firms should have regard to in market exchange and private contracting and which any arbitral tribunal should be required to comply with, are to maximise welfare by:

- ensuring that efficient entry and competition in that or any other market is not prevented, restricted, delayed or lessened
- promoting efficiency including dynamic, allocative and productive efficiency in the production and supply or acquisition of the relevant services
- supporting the combination of competition and innovation to their mutual benefit and encouraging greater dynamic efficiency with, if there is a trade-off, precedence over short-term static efficiency gains

A.8 Subject to the broad principle of the promotion of the interaction of competition and innovation, there is little need to add to the broad principles referred to above.

Summary answer to Question (3)

QUESTION (3): What are the advantages and drawbacks of communicating detailed statements of policy to the regulatory institution via Government statements as occurs in s.26 of the Commerce Act?

A.9 Government intervention in the access process through communicating detailed statements of policy to the regulatory institution is inappropriate. Government intervention is vulnerable to outside influence.

A.10 Once the improved access regime is in place, the Government should observe the outcome of the process before making any changes. If further changes are necessary, the Government should implement the changes through normal legislative processes which are transparent and subject to public scrutiny and accountability.

Summary answer to Question (4)

QUESTION (4): Should the wording guiding the regulatory institution as to how much weight to put on the s.26-type statements be stronger than the "have regard to" requirement of s.26: e.g., "be required to comply with"?

A.11 *The regulatory institution should only be required at most to "have regard to" any section 26-type statements, and should not "be required to comply with".*

Summary answer to Question (5)

QUESTION (5): What are the advantages and drawbacks of an arbitration process of the type set out in Appendix A? What are the advantages and drawbacks of Final Offer Arbitration?

A.12 The arbitration process of the type set out in Appendix A to the Discussion Paper generally would be effective in ensuring that access is provided in a manner that is timely, certain and predictable.

A.13 The need to establish a panel of arbitrators which is compulsory to the parties is questionable. The parties should be free to select their own arbitrator for dispute resolution.

A.14 Subject to any agreement of the parties, the arbitrators should determine the procedure to be followed in the arbitration. However, the arbitration procedure should be subject to a strict time limit for the rendition of an arbitral award. Appeals from decisions of the arbitrators should be strictly limited. A costs disincentive should be imposed against any appeals. Arbitral awards should be given effect to notwithstanding the appeal. The Court should have no power to order otherwise.

A.15 Because of the different circumstances which may arise, decisions on joinder of parties and consolidation of proceedings should generally rest with the entrants. The arbitrators should be empowered but not required to order joinder and consolidation when requested by a second (or subsequent) entrant with the consent of the monopoly owner.

A.16 The usual form of one-part Final Offer Arbitration is difficult to implement in the context of access disputes. A two-part approach to the arbitral award is more appropriate for access disputes. The first part of the arbitration would seek to define the service to be provided under the access agreement. The second part (the decision on pricing) should be made subject to sealed-bid Final Offer Arbitration.

A.17 The arbitral award should prescribe the terms and conditions for access.

Access Pricing Options

Summary answer to Question (6)

QUESTION (6): Having regard to the list of factors in paragraph 214, which of the pricing rules listed below best achieves the objectives of efficiency for interconnection in order to provide (a) local telephone service; (b) long-distance service; and (c) other telecommunications services, such as cellular?

(a) pricing at long-run average incremental cost;

(b) the BW or Efficient Component Pricing Rule; (or BW less monopoly profits); and

(c) (in the case of two-way networks) the rule of "reciprocity" and related such as "bill and keep".

A.18 LRAIC guards against predatory pricing and also checks whether inappropriate interconnection prices invite uneconomic entry.

A.19 The Baumol-Willig rule fails to achieve overall economic (allocative, productive and dynamic) efficiency. It is therefore inappropriate as an access pricing principle.

A.20 Policy should encourage interconnection charges that are based on the principles of reciprocity, non-discrimination, unbundling and de-averaging and are equal to LRAIC or higher than LRAIC only as necessary to recover appropriate fixed and common costs.

A.21 The principle of reciprocity promises partially to correct the strategic imbalance that exists between the dominant incumbent and entrants.

Summary answer to Question (7)

QUESTION (7): Having regard to the list of factors in paragraph 214, which of the pricing rules listed above (or elsewhere) best achieves the objectives of efficiency for access to networks in other industries (such as electricity or gas)?

A.22 The present problem is in telecommunications. Therefore, it should be addressed first. However, many elements of the proposed solutions apply to other network industries. These solutions work best in the presence of substantial potential and actual competition. Today, of all network industries, telecommunications has the potential to be the most competitive. Thus, the proposed solutions apply best to telecommunications. Those solutions are proposed with this industry generally in mind and, more particularly, with the issue of interconnection to provide local service (using either fixed or wireless technologies) in mind.

Summary answer to Question (8)

QUESTION (8): What other principles (e.g., principles relating to the technical specifications of interconnection, or unbundling of components) are necessary to achieve the objective of efficiency in the telecommunications sector? in other sectors?

A.23 Other pricing principles that would further promote economic efficiency in the telecommunications sector include:

- the requirement that a network operator has to offer fair and reasonable access prices and other interconnection terms to competing and complementary network operators
- the principle of reciprocity for like termination services to counterbalance the strategic advantages which the dominant incumbent enjoys as a result of its unearned historical monopoly position
- a principle that there be no network operator-specific price discrimination to prevent anti-competitive favouritism among competing network operators by the dominant incumbent
- a principle that interconnection charges are unbundled so that those services needed by another network operator can be offered on a stand-alone basis
- a principle that interconnection charges be de-averaged so that they take account of different geographic and customer markets
- a principle that monopoly rents be excluded from interconnection charges

A.24 There are a number of other factors which would also achieve the objective of efficiency in the telecommunications sector. These factors are considered in detail elsewhere in these Submissions. In particular, however, greater efficiency will be achieved by the adoption of a mandatory comprehensive disclosure regime applicable to the dominant incumbent. That regime will ensure that negotiations and arbitration on prices and other terms and conditions will be conducted on a considerably more informed basis than is possible today.

A.25 Telecom has an incentive to understate its marginal costs of production in its competitive markets and then employ the Baumol-Willig rule to charge an exclusionary interconnection once vis-a-vis another fellow network operates.

Dealing with social obligations

Summary answer to Question (9)

QUESTION (9): Which of the following two options is more likely to achieve the objectives of (i) ensuring the costs of the social obligation are contributed to by all users of a natural monopoly facility in a way that does not distort competition between them; and (ii) allocating the costs of the obligation on a basis which minimizes the economic distortions created?

(a) interconnection pricing rules which do not require separate estimation and verification of the social obligation costs (such as the BW rule); or

(b) separate estimation and verification combined with some means of allocating the cost between competitors (whether in relation to the interconnection pricing or not).

A.26 Telecom's assertions that its agreement with its shareholder to restrict residential tariffs is in fact an obligation have not been demonstrated. Other network operators suffer a significant information disadvantage in relation to this agreement.

A.27 Telecom should be subject to a mandatory comprehensive disclosure regime requiring it, as the dominant incumbent, and as an incident of its agreement with its shareholder to restrict residential tariffs, to disclose the agreement's contribution element for every economically distinct residential and business market and service.

A.28 To the extent, therefore, that Telecom's agreement with its shareholder to restrict residential tariffs does in fact impose an observable "obligation" in any economically distinct residential and business market and service, then that "obligation" should be recovered by Telecom by way of the interconnection charge payable in respect of that distinct market or service.

Summary answer to Question (10)

QUESTION (10): Is there an economically efficient methodology for estimating social obligation costs? What are the advantages and drawbacks of the two methodologies ("fully distributed costs" and "avoidable incremental costs") mentioned in the test?

A.29 On the basis of the answers set out in paragraphs A.26-A.28, there is no need to determine an economically efficient methodology for estimating the cost, if any, of Telecom's agreement with its shareholder to restrict residential tariffs.

Summary answer to Question (11)

QUESTION (11): Is there an economically efficient methodology for allocating social obligation costs among the competing networks? What methodology should be used for allocating the Kiwi Share costs among competitors?

A.30 On the basis of the answers set out in paragraphs A.26-A.28, the economically efficient method for allocating the costs, if any, of Telecom's agreement with its shareholder to restrict residential tariffs among competing network operators is to impose a mandatory comprehensive disclosure regime on Telecom which enables the so-called "obligation", when it exists in relation to a particular market or service, to be recovered by Telecom by way of the agreed interconnection charge for that market or service.

Summary answer to Question (12)

QUESTION (12): How should the costs of the auditor be shared among the competitors?

A.31 If it is necessary for an independent auditor to audit and verify the disclosure made by Telecom pursuant to the mandatory disclosure regime, the cost of the auditor should be shared by both the network operator requesting the audit and Telecom. However, there should be power to require Telecom to meet all the costs of the auditor where it has not originally disclosed the appropriate information.

The Gatekeeper

Summary answer to Question (13)

QUESTION (13): Is it possible to satisfactorily delegate from the Government the authority to invoke an access pricing regime? Do the risks outweigh the benefits?

A.32 The question is not whether or not it is possible to delegate satisfactorily from the Government authority to invoke an access pricing regime, or whether or not the risks outweigh the benefits. Market processes must be enhanced in telecommunications to achieve Government policy objectives of maximizing this sector's contribution to overall economic growth through promotion of economic efficiency. These enhancements should take the form of an industry-specific two-part arbitration process guided by broad economic principles which promote dynamic and allocative efficiency and economic welfare, accompanied by strengthened disclosure requirements.

A.33 If these enhancements are made, there is no need for the Government to delegate, satisfactorily or not, the authority to invoke an access pricing regime. There is equally no need to consider whether the risks of doing so outweigh the benefits. Put another way, if policy makers enhance the regime as BellSouth submits to enable market processes and private contracting to achieve Government policy objectives, there is no need for a Gatekeeper of the kind envisaged by the Discussion Paper.

A.34 On this basis, therefore, the de facto "Gatekeeper" is compulsory arbitration accompanied by a compulsory detailed disclosure regime applicable to the dominant incumbent. There is no need for a Gatekeeper to be appointed in respect of the establishment of an arbitral regime for the telecommunications industry.

Summary answer to Question (14)

QUESTION (14): Which of the options set out below best meets the objective of promoting economic efficiency subject to timeliness, certainty and predictability, taking into account any possible regulatory costs? In particular, is the judgment about when to invoke an access pricing regime best made by the Crown?

(a) the courts, subject to the Commerce Act;

(b) a statutory regulatory body, subject to broad legislative principles;

(c) a statutory regulatory body, subject to detailed legislative principles;

(d) Government acting under statutory powers and subject to broad legislative principles; and

(e) the Government acting under statutory powers and subject to detailed legislative principles.

A.35 On the basis of the answers set out in paragraphs A.32-A.34, there is no need to consider which of the options set out above best meet the objective of promoting economic efficiency subject to timeliness, certainty and predictability, taking into account any possible regulatory costs. There is no need to consider whether the judgment about when to invoke an access pricing regime is best made by the Crown. Neither of these questions arises for consideration.

Summary answer to Question (15)

QUESTION (15): Is it possible to define a threshold, for determining which disputes should have access to a new access regulation regime, that meets the objectives set out in paragraphs 235-237? Do the principles set out in paragraphs 243-244 meet these objectives? If not, what principles might define such a threshold?

A.36 On the basis of the answers set out in paragraphs A.32-A.34, there is no need to consider whether it is possible to define a threshold, or to determine which disputes should have access to a new access regulation regime. Whether or not the principles so set out meet the objectives also so set out, and whether or not there are other principles which might define such a threshold, none of these questions arises for consideration.

Summary answer to Question (16)

QUESTION (16): Is it necessary to distinguish formally between bona fide downstream competitors and other end-users or customers in the telecommunications industry for the purposes of determining access to a new access regulation regime? Does the suggestion in paragraph 246 satisfactorily make this distinction?

A.37 On the basis of the answers set out in paragraphs A.32-A.34, there is no need to consider whether it is necessary to distinguish formally between bona fide downstream competitors and other end-users or customers in the telecommunications industry for the purpose of determining access to a new access regulation regime. The question does not arise for consideration.

APPENDIX B

Pricing access

Introduction

B.1 This Appendix considers access pricing principles in the telecommunications sector in New Zealand. BellSouth believes that it is possible to derive a set of access pricing principles which should, in principle, form the guiding principles for the negotiation and, if necessary, the arbitration of interconnection charges.

B.2. At this point in time, BellSouth does not propose that these access pricing principles be enacted as such into legislation, whether generally for a range of network industries or specifically for telecommunications.

B.3 Accordingly, this Appendix:

- sets out BellSouth's submissions on the access pricing principles to guide negotiations and arbitration for the telecommunications sector in New Zealand
- discusses and analyses:
  - the issues raised in this context in the Discussion Paper
  - the options available in this context

The summary of BellSouth's answers to Questions (6)-(8) asked on page 14 of the Discussion Paper is found in Appendix A to these Submissions.

Summary of submissions on access pricing principles

B.4 Any access pricing principles that should be considered for controlling the interconnection or access price in the telecommunications sector in New Zealand should[52]:

- promote economic efficiency
- be timely
- have a high degree of predictability

B.5 BellSouth agrees with the statement in the Discussion Paper[53] that the:

> relevant criterion for identifying which access pricing rule is most appropriate is economic efficiency (i.e., productive, allocative and dynamic efficiency)

B.6 BellSouth submits that the access pricing principles which best achieve the objective of efficiency for interconnection in the telecommunications sector in New Zealand are:

52 As stated in paragraph 209 of the Discussion Paper.
53 See paragraph 209 of the Discussion Paper.

- Principle 1: *mandatory interconnection of networks* in conjunction with the safeguards of the incremental cost test
- Principle 2: *reciprocity* of interconnection charges
- Principle 3: *non-discrimination* across network operators for the same service
- Principle 4: *unbundling* of interconnection charges
- Principle 5: *geographic de-averaging* of interconnection charges
- Principle 6: *exclusion of monopoly rents* from interconnection charges

B.7 BellSouth submits that the Baumol-Willig rule is inappropriate for the telecommunications sector of New Zealand. This rule consists of:

- a *principle*: the dominant incumbent is paid its full opportunity costs, including monopoly rents, but takes no risk
- an *implementation mechanism*: the full opportunity cost is measured residually

B.8 The Baumol-Willig rule is inappropriate in a regime of light-handed regulation, such as in New Zealand, because:

- the principle is inappropriately narrow in scope
- the implementation mechanism is mathematically biased in favour of the dominant incumbent

B.9 Moreover, the Baumol-Willig rule:

- fails to promote or achieve overall (allocative, productive and dynamic) efficiency even in the "simplest, static and no-uncertainty" context of paragraph 124 of the Discussion Paper
- acts to perpetuate high prices, limit entry, restrict, prevent and even eliminate competition as well as retard innovation

Only under extremely exceptional conditions, far-removed from the telecommunications sector in New Zealand, could the Baumol-Willig rule be appropriate.

B.10 The basis for this submission on the Baumol-Willig rule is set out in Appendix C to these Submissions.

Analysis and discussion of issues and options

Pricing principles to achieve efficiency in telecommunications in New Zealand

Objectives of public policy

B.11 The goal of policy for the telecommunications sector in New Zealand is to pursue allocative, productive and dynamic efficiency. Dynamic efficiency is a good measure of the effectiveness of policy towards the telecommunications industry. To pursue efficiency, policy makers must create a legal and business environment where firms can freely compete on an equal footing. Economic theory predicts that competition on a level playing field will lead to efficient production, efficient pricing and the highest benefits for consumers and producers.

B.12 The present competitive playing field in the telecommunications sector in New Zealand is far from level. The existence of a dominant incumbent, the "adoption" of the Baumol-Willig rule and the weakness of competition law each enable the dominant incumbent former state monopolist to dictate terms that limit competition and marginalise or exclude actual and potential entrants.

B.13 This Appendix suggests some access pricing principles which would make that playing field more level. Even so, the dominant structural position of the incumbent (and the resulting tilting of the playing field) presents very considerable challenges to policy makers in the context of a light-handed regulatory regime.

B.14 If these access pricing principles are adopted:

- competition will be strengthened
- prices will fall
- new services will be deployed at an accelerated rate
- quality will be enhanced
- more efficient network usage will be achieved
- greater overall efficiency will be achieved

B.15 In this context, dynamic efficiency is fundamental. The present titled competitive playing field severely restricts the possibilities for innovation which are vast in telecommunications.

B.16 These proposed access pricing principles are likely to increase both dynamic and static efficiency. Occasionally, there may be a trade-off between static and dynamic efficiency. Schumpeter argued in favour of temporary monopoly profits to reward firms for innovative behaviour, not in favour of a franchise which would stifle innovation for fear that its position is threatened. Telecom is clearly earning monopoly profits. But those monopoly profits cannot be interpreted as a proper return for its ingenuity and initiative. Instead, those monopoly profits are the simple result of a monopoly franchise enjoyed by Telecom by historical accident. Those monopoly profits do not produce the benefits that Schumpeter foresaw which would come from rewarding innovative entry into these markets.

Nature of the access pricing problem: lack of access pricing principles and lack of information sharing

B.17 The access pricing problem which arises today in the New Zealand telecommunications sector is a result of the lack of appropriately defined and understood access pricing principles that can guide network operators to negotiate and agree interconnection charges without recourse to lengthy and costly dispute resolution procedures. For example, there is today no agreed basis to require, or provide incentives to, the dominant incumbent to charge a non-discriminatory, fair and reasonable amount. Telecom today therefore has no incentive to charge fair and reasonable access prices. Telecom has every opportunity to charge access prices which minimise competitive threats.

B.18 This access pricing problem is also a result of the extreme information asymmetries which exist today in telecommunications in New Zealand. It is therefore essential that the dominant incumbent be subject to a mandatory disclosure regime which enables other network operators to negotiate access prices and other terms and conditions on an informed basis.

The Baumol-Willig Rule is not an appropriate access pricing rule; monopoly rents should be excluded from interconnection charges

B.19 The Baumol-Willig rule:

- fails to promote or achieve overall (allocative, productive and dynamic) efficiency even in the "simplest, static and no-uncertainty" context contemplated in the Discussion Paper[54]

- acts to perpetuate high prices, limit entry, restrict, prevent and even eliminate competition and retard innovation

Only under extremely exceptional conditions, far-removed from the telecommunications sector in New Zealand, could the Baumol-Willig rule be appropriate.

B.20 The basis for this submission on the Baumol-Willig rule is set out in Appendix C to these Submissions.

Principles of interconnection: mandatory interconnection, reciprocity of interconnection charges, non-discrimination across fellow network operators, unbundling of interconnection charges, geographic de-averaging and exclusion of monopoly rents

B.21 The access pricing principles which should be adopted are:

- Principle 1: *mandatory interconnection of networks in conjunction with the safeguards of the incremental cost test*

- Principle 2: *reciprocity of interconnection charges*

54 See paragraph 124 of the Discussion Paper.

- Principle 3: *non-discrimination across network operators for the same service*
- Principle 4: *unbundling of interconnection charges*
- Principle 5: *geographic de-averaging of interconnection charges*
- Principle 6: *exclusion of monopoly rents from interconnection charges*

B.22 The objective of these principles is:

- to encourage interconnection of networks in order to create services which have the effect of driving down prices and which meet unmet users service needs
- to create a level playing field where network operators can freely compete on an equal footing, leading to an efficient telecommunications sector
- to ensure that prices both stimulate efficient usage of networks and also provide correct signals for network operators to innovate

B.23 *Mandatory interconnection of networks.* A network operator is required to offer fair and reasonable access prices and terms and conditions to competing and complementary network operators.

B.24 This principle counteracts the tendency for a dominant incumbent to use its control of essential network facilities to restrict competition in markets for substitute services. A minimal restriction on a dominant incumbent is that interconnection charges fall between average incremental cost and average stand-alone cost.

B.25 Care needs to be taken in computing stand-alone costs. It is necessary to ask what the costs are of providing access on a stand-alone basis given by best practice (i.e., the most advanced state of knowledge of, and expertise used by, any network operator). This requires the separation out only of those expenditures necessary to provide interconnection services. In addition, it is necessary to require that the dominant incumbent use in its computation, regardless of the actual technology used in its network, "best practice" technology. Otherwise, it will inflate the costs of interconnection.

B.26 In most circumstances, access prices below AIC would not be in the interests of a dominant incumbent. This possibility is a concern when the dominant incumbent attempts to drive out actual or potential suppliers of access services.

B.27 *Reciprocity of interconnection charges.* This principle means that the interconnection pricing schedule offered by network A to network B for calls that originate from network B and pass through or terminate in network A is the same as the interconnection pricing schedule offered by network B to network A for calls that originate in network A and pass through or terminate in network B.

B.28 Reciprocity is not always equivalent to a system of "bill and keep" unless the termination services are identical and net traffic flows are negligible.

B.29 Reciprocity is designed to counteract the ability of a dominant incumbent to use its greater bargaining power to extract superior interconnection terms and conditions from a weaker rival or a new entrant. The disparity in the relative sizes of the network operators is a principal source of this imbalance. Another source of this imbalance is the ability of the dominant incumbent to pre-commit to terms and conditions on the basis of its entrenched position.

B.30 In the absence of reciprocity, the dominant incumbent can disadvantage its rivals by charging exorbitant rates for incoming traffic. At the same time, it can extract very low rates to terminate traffic on its rival's network. When prices must be the same in both directions, the dominant incumbent will agree to lower access prices, especially if it terminates large amounts of traffic on rival networks. The result is lower final prices and, therefore, higher consumer welfare.

B.31 *Non-discrimination across fellow network operators for the same service.* A network operator must charge the same interconnection charge for the same service to any other network operator as it charges to itself. Thus, for example, network operator A providing call termination services to network operators X and Y, as well as to itself, must charge the same amounts $a = x = y$ to itself as well as to each of the other network operators. This principle has been called imputation when applied in bilateral relations only, i.e., to define charges between network operators A and X. This principle sets the same termination charge for all calls irrespective of their origination (international, long distance or local). Thus, it follows the general trend towards unbundling of telecommunications services. However, this principle gives the freedom to network operators to use any non-linear pricing scheme (such as quantity discounts).

B.32 This principle also requires that network operators providing interconnection purchase access services for their own products at disclosed rates. This principle precludes a network operator from charging less for its final services than for the sum of the various components used in its final service, and sold to rivals.

B.33 The non-discrimination requirement is designed to prevent a dominant incumbent from tailoring its interconnection charges to manage the competition among vertical service providers. It is likely that, among those providers that require interconnection, if there was no non-discriminatory interconnection, the ones that provide the closest substitutes to the dominant incumbent's services will face the highest interconnection charges.

B.34 Discriminatory interconnection charges also permit a dominant incumbent to extract better the rents available from the services made available by rivals. Price discrimination in access services assists a dominant incumbent to "manage" competition in its downstream markets. In particular, it will have severely diminished incentives to innovate because most of the gains will be "taxed" away through interconnection charges.

B.35 *Unbundling of interconnection services.* This principle requires network operators to separate out those services needed by other network operators to terminate traffic and offer them on a stand-alone basis. It does not insist that network operators unbundle all the intermediate or final services that they provide.

B.36 This principle is intended to deal with the ability of a dominant incumbent effectively to raise interconnection charges to exclude a rival, or at least to extract its profit through a "price squeeze". Without unbundling, a dominant carrier can skirt the reciprocity principle by offering a highly bundled termination service at a correspondingly high price. Incapable of providing many components of the bundle, a rival would effectively be required to pay high termination charges. Unable to reciprocate with a like service, the rival would charge a much lower price for a more basic termination service.

B.37 *Geographic de-averaging of interconnection charges.* Interconnection charges should take account of different geographic markets and different customer markets. At its most basic, for example, this principle means that interconnection charges should differ between residential and business customers in different parts of the country. This principle counteracts the tendency of the dominant incumbent to shift its costs between different geographic and customer markets.

B.38 *The exclusion of monopoly rents from interconnection charges.* Inclusion of monopoly rents in the interconnection charges, as the Baumol-Willig rule proposes, creates significant adverse economic inefficiencies. This principle is discussed in detail in Appendix C of these Submissions.

Justification and intuition of these principles of interconnection

B.39 The crux of the intuition of these principles lies in the recognition that, today, the telecommunications sector in New Zealand is essentially a network of interconnected networks (commonly called a "network of networks"), rather than customers connecting to a natural monopoly provider. The structure of a network of networks is complex as it encompasses both horizontal and vertical elements[56]. Traditional public policy remedies that work well in purely horizontal or vertical situations prove inadequate. The policy solution lies in finding the appropriate principles to achieve efficient interconnection of *multiple two-way networks.*

B.40 Economic analysis shows that in an unregulated market interconnection charges are expected to vary widely depending on the sizes of competing local networks and the ability of a dominant incumbent to precommit on the level of the interconnection charges to implement a price squeeze on an entrant or rival. Equality of interconnection charges for calls that go in opposite directions in two-way networks occurs in these models of an unregulated network of networks only when the network operators are strategically symmetric and can act simultaneously. In this case, the ability of either network operator to implement a price squeeze on the opponent is largely restricted. In an unregulated network of networks, strategic inequalities also result in higher prices for end-to-end final services. This therefore results in reduced consumer satisfaction. The lowest prices for end-to-end services occur when the competing local networks have the same strategic power.

55 See Economides and White (1994) and Economides (1995).

B.41 In the absence of adequate regulation, a dominant local network operator that has the ability to set interconnection charges earlier than smaller network(s) can:

- set high charges to "price squeeze" smaller networks
- reduce the amount of satisfaction that a consumer may get from subscribing to a smaller network
- lock in current customers making it costly for them to switch to competing networks

B.42 *Thus, a dominant local network operator can use interconnection charges as a tool of horizontal competition against a direct competitor that offers a similar service*.

B.43 It is vital from a policy perspective to reduce the tilt of the playing field that today overwhelmingly benefits the dominant incumbent. In the absence of a structural solution (such as the divestiture of AT&T), and given a regime of light-handed regulation and ineffective competition law, the *only* available instruments are guidelines or restrictions affecting the conduct of network operators. It is for this reason that BellSouth proposes broad legislative principles and a mandatory arbitral regime in these Submissions.

B.44 It is essential that the *broad* legislative principles selected lead network operators in their negotiations and, if necessary, any arbitrators to agree on, or to determine, interconnection prices which would in effect be agreed or determined if the following access pricing principles were actually adopted in their private contract. Put another way, the *board* legislative principles must be designed to achieve in practice the result that would be achieved if the *specific* access pricing principles were adopted.

B.45 Analysis of theoretical models shows that the ability of a dominant incumbent to use its strategic power through precommitment on the level of interconnection charges is severely restricted by the principles defined earlier:

- mandatory interconnection ensures that small networks are not immediately excluded
- reciprocity of interconnection charges ensures that strategic power is almost equally divided between two network operators of different sizes and quite different abilities to precommit. Even when the dominant network operator is able to precommit on interconnection charges, the reciprocity principle removes the strategic power from the dominant incumbent. If the reciprocity principle is not applied, the dominant incumbent has an incentive to choose a high interconnection charge and have the entrant respond by a low interconnection charge. But this is ruled out under reciprocity
- non-discrimination across network operators for the same service ensures unbundling of termination service. Since some of the relationships of other fellow networks to the dominant incumbent are essentially vertical while others are essentially horizontal, the dominant incumbent has an incentive to use